

Paying Down the Debt

Although the outlook for the federal budget is bright over the next 10 years, the aging of the U.S. population and the continued growth of health care costs will eventually cause major structural shifts in the budget and in the amount of resources directed toward the elderly. Spending on Social Security, Medicare, and Medicaid (which finances some health benefits for low-income elderly people) could more than double over the next 40 years as a share of the nation's income—climbing from 7.5 percent of gross domestic product (GDP) in 1999 to almost 16.7 percent in 2040. In addition, substantial budget deficits will reemerge during that period unless current policies are changed.

One policy option that has attracted considerable attention from policymakers and the public is saving annual budget surpluses and paying down the federal debt. Indeed, federal debt held by the public has already declined from about 50 percent of GDP in 1995 to about 35 percent in 2000.¹ Continuing to pay down that debt could provide additional economic benefits and give policymakers more flexibility to deal with the fiscal implications of an aging population. It could also help prepare the United States for unexpected events. By expanding the nation's saving, it could boost the stock of private capital and increase GDP. Over time, the economy could be larger, and a greater fraction of its income could be available for future consumption. As a result, future workers could be better able to bear the heightened burden of a graying population.

The Congressional Budget Office (CBO) projects that in the absence of new legislation, budget surpluses would be sufficient by 2006 to pay off all of the federal debt available for redemption. What would happen to the budget after that? If current laws that control revenues and outlays remained unchanged, the government would begin to accumulate a stock of nonfederal assets (such as stocks and bonds), which could grow to almost \$3.2 trillion by 2011. Such large investments by the federal government in the private sector would be unprecedented.

Trends in Government Debt

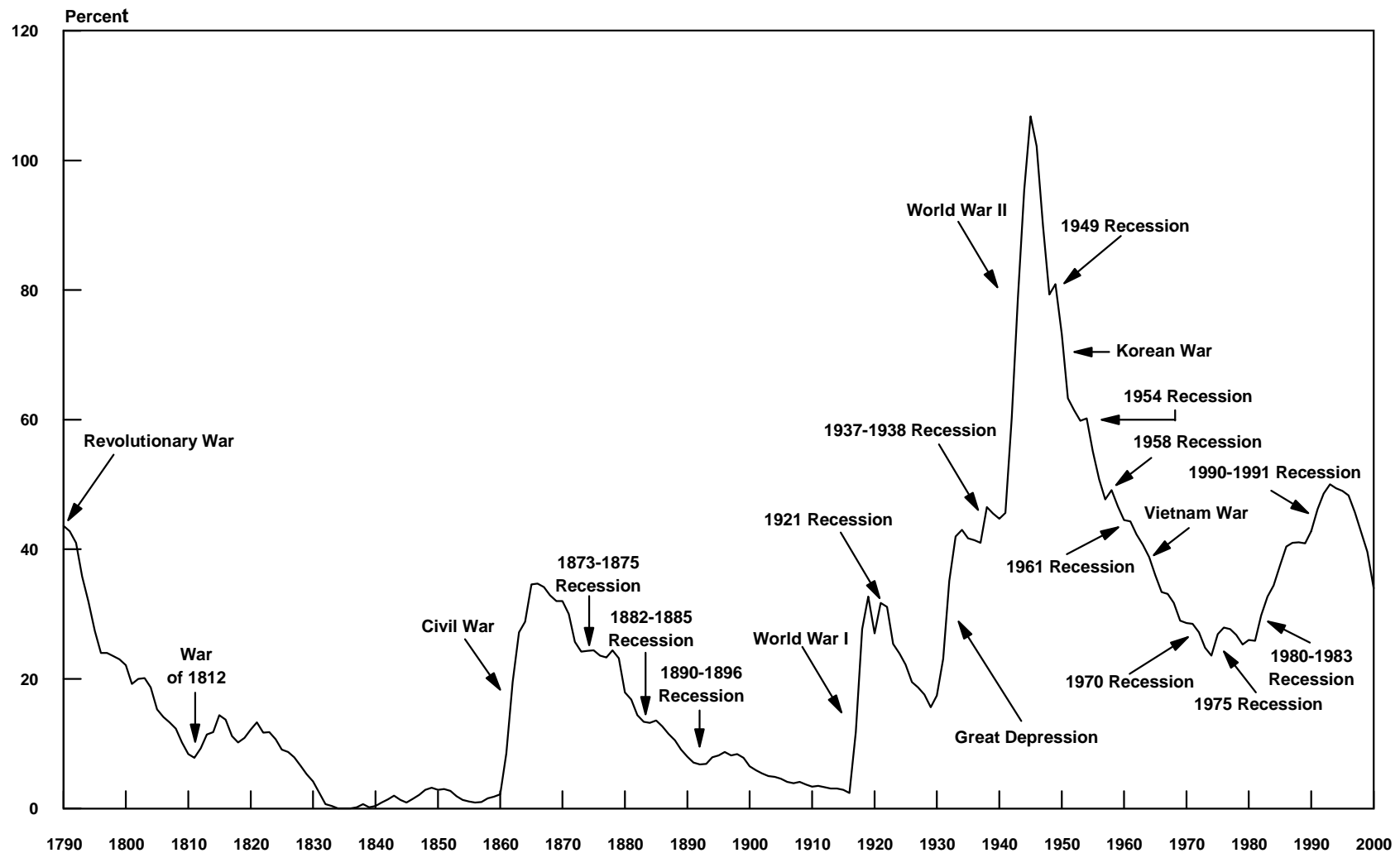
Whenever the federal government's total yearly expenditures exceed its total yearly revenues, the government runs a budget deficit. If the Treasury does not finance that deficit by drawing down its holdings of cash, gold, or other assets, the government has to borrow funds from the public. That additional borrowing increases the government's debt held by the public.

The situation is not unlike what happens when a family borrows on a credit card. The balance on the card is a debt, which carries finance, or interest, charges as long as the debt is outstanding. The family can reduce its debt by paying off more than it spends (including finance charges) each month.

Large budget deficits arise most often in periods of fiscal stress, such as times of war or during the Depression. Surpluses are more likely to appear in periods of prosperity, when tax revenues are high and the

1. Federal debt held by the public is debt issued by the federal government and held by nonfederal investors. In this chapter, "debt" refers to debt held by the public, unless otherwise indicated.

Figure 1.
U.S. Federal Debt Held by the Public as a Percentage of Gross National Product, 1790-2000



SOURCE: Congressional Budget Office.

demands on social welfare and other programs are low. Deficits or surpluses result from government policies that govern spending and taxation, combined with the performance of the economy. The level of debt is the residual outcome of those policies over a period of many years. (For a brief history of federal debt, see Box 1.)

Sometimes, such as now, the debt itself becomes a focus of policy interest. Although the level of debt as a percentage of gross national product (GNP) has fallen from its recent peak in fiscal year 1993, it remains high relative to any period other than World War II and its aftermath (see Figure 1).² At the end of fiscal year 2000, total debt held by the public stood at \$3.4 trillion, or about 35 percent of GNP. The unusually large peacetime deficits of the 1980s that contributed to federal debt gave rise to new policies to limit deficit spending. For example, the Budget Enforcement Act of 1990 established caps on discretionary spending; it also set up budgetary procedures that made it more difficult to pass legislation that reduced revenues or increased spending on mandatory programs.

Some other advanced nations have more-severe debt burdens than the United States does (see Figure 2). Their problems will be exacerbated as their populations age and their social security commitments become a heavier burden. In recent years, several European countries have actively sought to reduce their annual deficits and total debt in order to qualify for membership in the European Monetary Union. For its part, Russia is facing the adverse consequences of having defaulted on part of its debt.

Although the level of U.S. government debt has varied widely in the past, it is reasonable to assume that above some level, federal debt becomes a serious burden. Building up that debt transfers current costs to future taxpayers, who will have to pay interest on the debt. That may be an appropriate way to finance an extraordinary expenditure, such as a war, particu-

Box 1. **The History of Federal Debt**

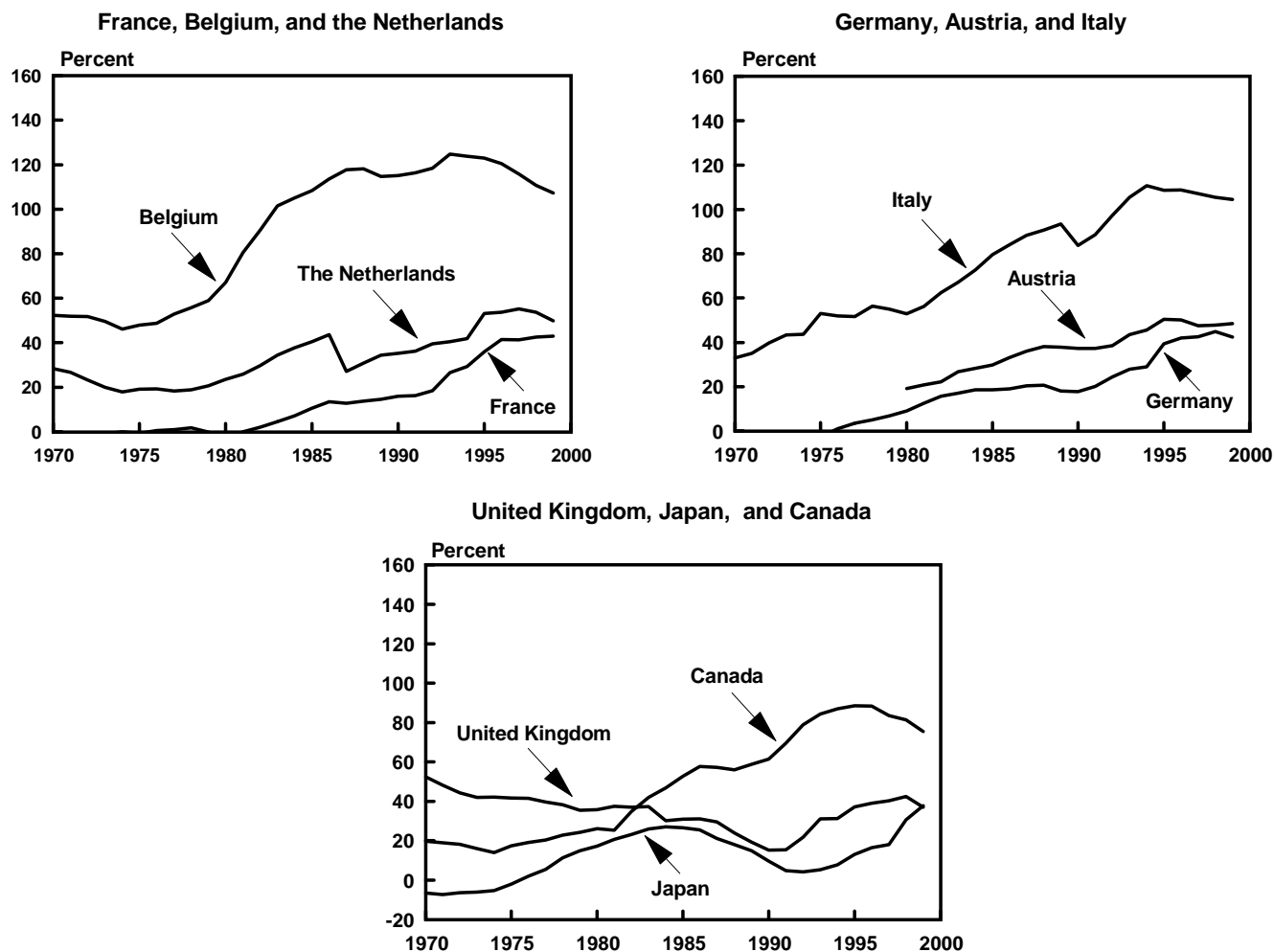
The United States began its life as a nation with a substantial debt—more than 40 percent of gross national product (GNP)—because in one of its first budgetary decisions, the new republic agreed to assume the Revolutionary War debt of the states in order to establish the creditworthiness of the federal government. Since then, the ratio of federal debt to GNP has generally fallen in peacetime and risen very sharply in times of war (as well as during the later stages of the Depression). Lesser economic disruptions—recessions—have tended to cause temporary deficits and slightly raise the ratio of debt to GNP, but in most cases they did not alter the general downward trend of that ratio in peacetime (see Figure 1). The debt ratio stabilized in the 1970s; it began to increase in the 1980s when large budget deficits emerged. Since 1995, however, it has fallen significantly. In 2000, the ratio of federal debt to GNP stood at 35 percent, down from about 50 percent in 1995.

During the 1830s, revenues from tariffs and land sales were sufficient to reduce federal debt nearly to zero. However, the federal government did not redeem all of its debt; instead, it began to accumulate assets (in the form of bank deposits), and by 1834, the value of the Treasury's deposits exceeded the value of its outstanding debt. By 1837, the federal government had so much revenue that it remitted substantial payments to the states. (Those payments were described as loans at the time, but they did not carry interest and were never repaid; they were the forerunners of today's federal grants to the states.) The debt remained low until the Civil War, when it shot up to almost 40 percent of GNP.

During the 20th century, debt reduction occurred for a variety of reasons. In the decade after World War I, fiscal discipline probably caused much of the reduction in the debt ratio. In the period after World War II, by contrast, the federal budget ran few surpluses and the decline in debt as a percentage of GNP came about largely from the growth of nominal GNP—reflecting strong productivity growth in the 1950s and 1960s and inflation in the 1970s. That postwar decline in the debt ratio was aided by the fact that much wartime borrowing had been on extremely favorable terms, so interest payments did not rise nearly as much as the debt. The most recent decline in debt as a share of GNP stemmed mostly from the extraordinary economic growth of the 1990s, which significantly boosted revenues. Reductions in defense spending and a slowdown in the growth of health care spending also contributed to reducing annual budget deficits.

2. Figure 1 compares debt with gross national product rather than the more familiar gross domestic product because GNP is the measure used in the historical data. GNP measures the total income of all U.S. residents (including net payments for capital and labor income earned in other countries). GDP measures the income produced on U.S. soil. The difference between the two was about \$10 billion in 1999.

Figure 2.
Net Government Debt of Selected Countries as a Percentage of Gross Domestic Product



SOURCE: Congressional Budget Office using data from the Organization for Economic Cooperation and Development.

NOTES: Net government debt is measured as the net financial liabilities of a country's general government, which consolidates central, state, and local government accounts, social security funds, and nonmarket, nonprofit institutions controlled and financed mainly by government units.

Conceptual revisions in the data series occur for the Netherlands in 1987 and 1995, for Germany in 1995, for Italy in 1990, and for the United Kingdom in 1984.

larly if it seems likely that future taxpayers will benefit from that expenditure. But even a moderate level of debt can be costly to maintain, both because of the interest that must be paid on it and because the debt tends to compete with and displace private capital, thus slowing the growth of the economy.³ Determining the consequences of debt requires analyzing how

it shifts the burden of taxation to different groups of taxpayers over time as well as balancing the various costs and benefits associated with it.

Long-Term Pressures on the Federal Budget

Over the next several decades, the federal budget will face pressure from three fundamental sources. First,

3. Interest payments on debt can impose costs on the economy as a whole because they may be financed by taxes that distort economic decisionmaking and reduce the efficiency of the economy. Those efficiency losses tend to rise disproportionately with the tax rate.

the large baby-boom generation will begin to reach retirement age in the next decade or so and become eligible to receive benefits from Social Security and Medicare. Baby boomers whose income is low enough will also qualify for benefits under Medicaid, which pays for long-term care and other services. Second, people will probably continue to live longer than they did in the past and spend a longer period of their life in retirement. Third, the advance of medical technology may put upward pressure on the costs of providing health care.

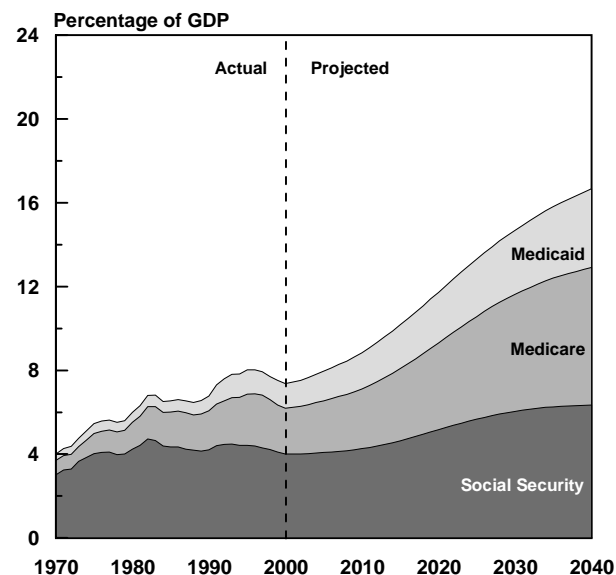
Those demographic and economic developments will significantly increase the number of retirees per worker and affect both federal spending and revenues. In 1960, the United States had 5.1 workers for each beneficiary in the Social Security program; today, the ratio is about 3.4 to 1. That figure is projected to fall to just 2.1 workers per beneficiary in 2040. As a result, the growth of federal spending for Social Security, Medicare, and Medicaid will speed up rapidly, while the growth of revenues will slow as older workers leave the labor force.

CBO's Long-Term Projections

What will happen to the budget and the economy if federal policies do not change in response to those demographic and economic trends? The Congressional Budget Office addressed that hypothetical question by developing projections for the budget under a wide variety of assumptions. CBO's long-term projections suggest that the share of GDP devoted to federal health and retirement programs will increase significantly and that a long-term imbalance between spending and revenues will probably emerge.⁴ For example, under one midrange set of assumptions, spending on the major health and retirement programs will rise from 7.5 percent of GDP in 1999 to about 16.7 percent in 2040 (see Figure 3). That increase will have a major impact on the federal budget: spending for Social Security, Medicare, and Medicaid combined will climb from about 45 percent of federal outlays (excluding interest costs) in 1999 to about 70 percent in 2040 (see Figure 4).

4. See Congressional Budget Office, *The Long-Term Budget Outlook* (October 2000). Those long-term projections are based on the 10-year projections that CBO published in July 2000 and do not incorporate revisions to the 10-year projections published in January 2001.

Figure 3.
Spending for Social Security, Medicare, and Medicaid Under CBO's Midrange Assumptions, 1970-2040



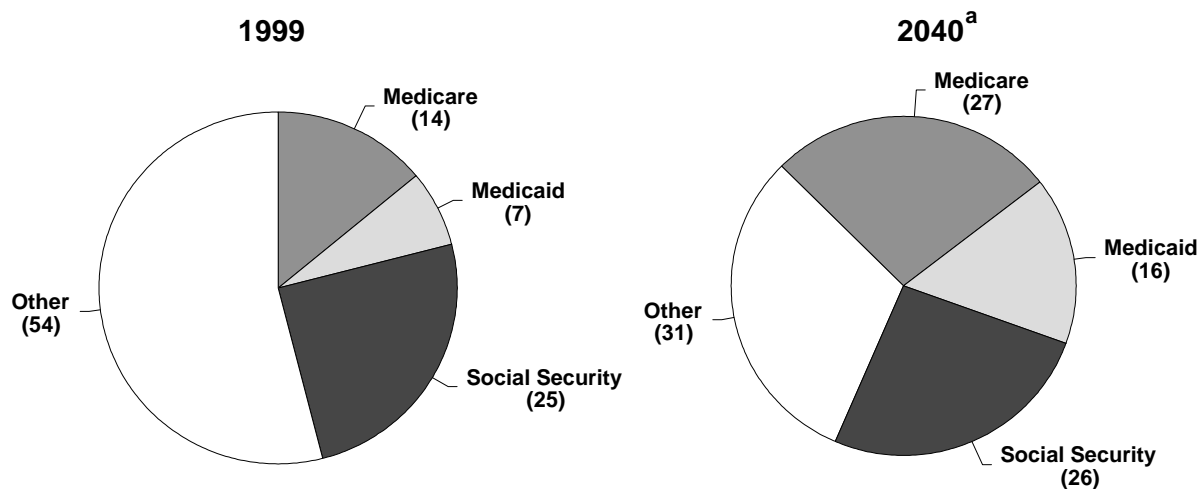
SOURCE: Congressional Budget Office.

NOTE: Spending is based on measures from the national income and product accounts. For details of CBO's midrange assumptions, see Congressional Budget Office, *The Long-Term Budget Outlook* (October 2000).

The rising share of spending for the elderly will affect the outlook for the federal budget surplus and debt held by the public. Although the outlook for the surplus is very positive over the next 10 years, fiscal pressures are likely to bring back deficits and eventually cause the federal debt to escalate as a percentage of GDP (see Figure 5). CBO also estimates that the increase in debt could significantly slow the growth of the economy. (CBO's projections focus on the balance of the total budget—not the Social Security or Medicare trust funds—because the trust funds by themselves do not illuminate the central economic issues relating to debt policy. See Box 2 on page 20 for details.)

As unfavorable as they seem, those projections could turn out to be too optimistic. Pressures are growing to increase Medicare spending through a new prescription drug benefit, increased payment rates for health care providers, or both.

Figure 4.
Spending for Social Security, Medicare, and Medicaid as a Share of Federal Noninterest Spending
(In percent)



SOURCE: Congressional Budget Office.

NOTE: Spending is based on measures from the national income and product accounts.

a. Percentages in 2040 are based on the assumption that the off-budget surpluses in CBO's 10-year baseline projections are saved rather than used for spending or tax cuts. Most other assumptions about the fate of surpluses yield similar percentages.

Caveats About the Long-Term Projections

When assessing CBO's long-term projections, it is important to bear in mind that they are by their nature highly uncertain. They rely on demographic assumptions about future rates of mortality, fertility, and immigration; on economic assumptions about labor supply, saving, and productivity; and on budgetary assumptions about the future course of spending and taxes. The budget and the economy could turn out very differently than CBO expects today. Moreover, CBO's projections take into account some, but not all, of the potentially important interactions between the budget and the economy. (For example, they do not account for the effect of taxes on labor supply and saving.)

In addition, these projections are not predictions of what CBO thinks is likely to happen. Instead, the projections use simple assumptions to represent certain aspects of current policies and then illustrate what would happen if those policies were mechanically followed into the future. Of course, that is unlikely to occur: policymakers will surely modify tax and spending policies in the future. However, the

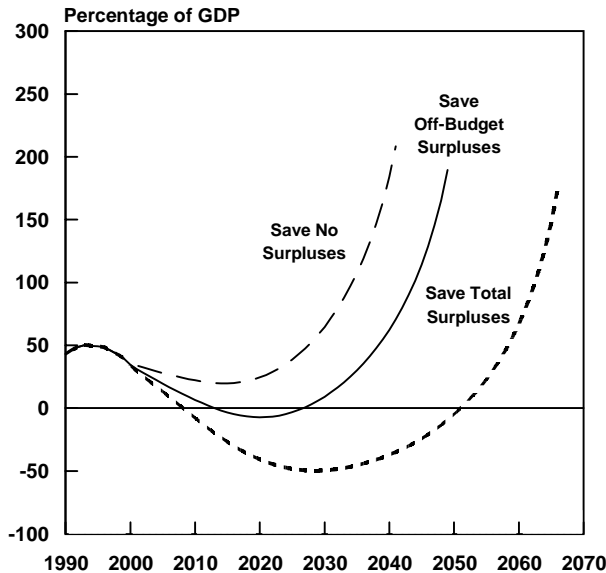
projections provide a useful benchmark because they demonstrate that changes in policy will be necessary and they give a rough estimate of the magnitude of those changes.

The Importance of Economic Growth

How can policymakers respond to the challenge of rising demand for health and retirement spending? Certainly, one way is for the government to pursue policies that foster economic growth. Although growth cannot alter basic demographic trends, it can ease the burden of high program costs by making more resources available to workers and retirees.

Running budget surpluses and thus paying down federal debt is one way to foster economic growth because it increases national saving and makes more funds available for investment in business equipment, structures, and other types of capital. Other ways to promote growth include changing tax and regulatory policies to improve efficiency and to encourage peo-

Figure 5.
Projections of Debt Held by the Public Under
Different Assumptions About Saving Surpluses



SOURCE: Congressional Budget Office.

NOTES: All of these projections use midrange long-term assumptions that are explained in Congressional Budget Office, *The Long-Term Budget Outlook* (October 2000).

Off-budget surpluses consist of the surpluses of the Social Security trust funds and the Postal Service. Under the "save off-budget surpluses" assumption, on-budget surpluses in 2000 through 2010 are zero, and off-budget surpluses match CBO's 10-year baseline for the off-budget accounts published in July 2000. Although CBO published a new 10-year baseline in January 2001, its projection of the off-budget surplus did not change much.

Under the "save no surpluses" assumption, the total surplus in each year from 2000 through 2010 is zero (an on-budget deficit offsets the off-budget surplus). Revising the assumptions to reflect CBO's 10-year baseline projections published in January 2001 would not significantly affect projections of debt under this assumption about surpluses.

Under the "save total surpluses" assumption, total surpluses (both on- and off-budget) in 2000 through 2010 match CBO's 10-year baseline for the total surplus published in July 2000. Using CBO's January 2001 baseline would substantially reduce the projected level of federal debt and increase the projected accumulation of nonfederal assets.

ple to work and save more, or increasing government spending on programs that are oriented toward investment rather than current consumption.

Yet economic growth is unlikely to eliminate budgetary imbalances by itself because it can also

lead to increased spending on many programs. For example, under the current formula for determining Social Security benefits, higher wages eventually translate into higher benefits (although with a substantial lag). Thus, even though the nation might be wealthier, it would still face a sharp increase in the resources necessary to pay for Social Security after the baby-boom generation retired. As a result, policymakers will most likely face hard choices about budget policy even if economic growth is higher.

The Effects of Paying Down the Debt

Paying down the debt could offer significant benefits. It could reduce the amount of resources that would have to be spent on servicing the debt, increase capital investment, and boost economic growth; it could enhance economic efficiency by smoothing tax rates over time and could make it easier for future generations of workers to bear the burden of an aging population; and it could give future policymakers more flexibility to deal with the unexpected. Paying down the debt could also affect participants in financial markets and could raise questions about the government's ownership of private assets.

Macroeconomic Effects

Debt reduction could increase national saving and the nation's pool of funds for capital investment both at home and abroad.⁵ Over time, the U.S. capital stock could grow larger and the nation could accumulate more net foreign assets. As investment in businesses' structures and equipment grew, workers would become more productive and earn higher wages. As a result, the United States could produce more goods

5. National saving would not necessarily rise dollar for dollar with an increase in the budget surplus because private savers might reduce their saving in response to the larger surplus. The reduction in private saving, however, would be unlikely to offset the surplus completely. See B. Douglas Bernheim, "Ricardian Equivalence: An Evaluation of Theory and Evidence," *NBER Macroeconomics Annual 1987* (Cambridge, Mass.: MIT Press, 1997), pp. 263-303; and Funio Hayashi, Joseph Altonji, and Laurence Kotlikoff, "Risk Sharing Between and Within Families," *Econometrica*, vol. 64, no. 2 (March 1996), pp. 261-294.

Box 2. Trust Fund Accounting

Some analysts suggest that government trust fund programs offer a way to accumulate public savings. They point to the Social Security trust funds as an example. However, government trust fund accounting can often be misleading. Simply because surpluses are recorded in a particular government account does not necessarily mean that governmental actions have contributed to national saving. The overall budget deficit or surplus better indicates the federal government's potential contribution to saving.

The federal budget includes more than 150 trust funds. They vary widely in size and purpose, but the best known ones fall into two categories: trust funds for major benefit programs (such as Social Security, Medicare, unemployment insurance, and retirement programs for federal employees) and trust funds for infrastructure programs (notably, the Highway and the Airport and Airway Trust Funds).

The federal government's trust funds, including those for Social Security, are simply accounting mechanisms: they record the income from earmarked taxes; from transfers from the general fund; from spending for benefit payments, purchases, grants, and administrative expenses; and from interest that accrues when income exceeds spending. They do not necessarily record the amount of resources that have been set aside to fund their programs, because surpluses in the trust funds may be offset by deficits elsewhere in the budget.

For example, making transfers from the general fund to the Social Security trust funds would improve the apparent solvency of the trust funds. At the same time, however, those transfers would increase the liabilities in the rest of the budget. Because the transfers would be nothing more than intragovernmental accounting transactions, they would have no direct effect on the overall budget, nor would they contribute to national saving.

The transfers could have indirect effects on the budget if they changed people's perceptions about the Social Security program and altered future decisions by policymakers, but the direction of those effects is uncertain. On one hand, the transfers might help to package debt reduction in a more palatable form by moving a portion of the on-budget surplus into the Social Security trust funds. On the other hand, the apparent improvement in the actuarial solvency of Social Security could lull the public into a false sense of complacency and lessen pressure for making changes in the program now, when corrective action might be less difficult.

Ultimately, the government's ability to pay future commitments, whether they are Social Security benefits or some other payments, depends on the size of the economy—not on the balances attributed to various trust funds.

and services and have more resources available to support an aging population.

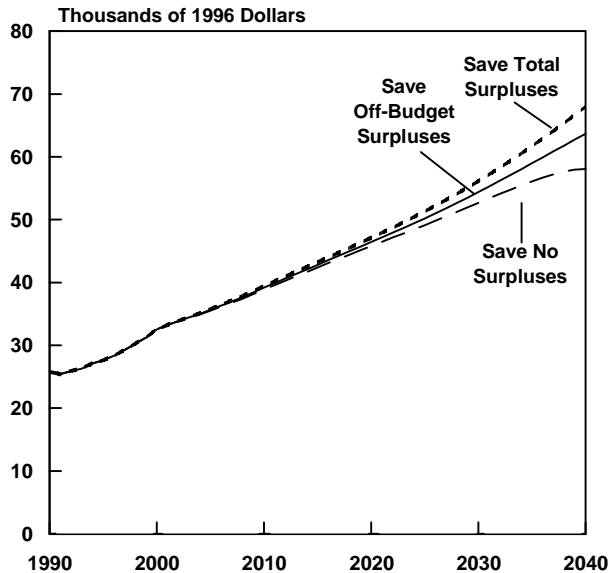
Different paths for government saving over the next decade could have significant long-term implications for economic growth. For example, if the projected off-budget surpluses (largely from Social Security) were saved over the next 10 years and used to pay down debt, national saving could increase, the capital stock could grow larger, and workers could become more productive. Under one seemingly reasonable scenario, real (inflation-adjusted) GDP per person could be about \$5,500 (10 percent) higher by 2040 than it would be if those surpluses were used for additional government consumption of goods and services (see Figure 6).⁶

To achieve that higher level of future GDP, current generations would have to forgo some tax cuts or spending increases today. Indeed, that trade-off is the essence of debt reduction policy: by limiting consumption today, current generations can build a larger economy in the future, which will be able to support higher levels of consumption. Some of those gains in consumption could accrue to baby boomers in their retirement. However, unless debt reduction is used to shift some resources and consumption from current generations to future generations, it will not increase GDP permanently.⁷

6. That estimate is based on CBO's midrange assumptions for population, productivity, and medical costs. For details, see Congressional Budget Office, *The Long-Term Budget Outlook*.

7. Moreover, consumers who have access to capital markets and are forward looking will not reduce their current consumption and increase saving if policymakers simply shift the timing of their after-tax income.

Figure 6.
Real Gross Domestic Product per Capita Under
Different Assumptions About Saving Surpluses



SOURCE: Congressional Budget Office.

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tax rates over time. (The marginal tax rate is the rate that applies to an additional dollar of taxable income.) If the debt was not paid down and current spending policies did not change, future taxpayers could face substantially higher tax rates to cover the growing costs of Social Security, Medicare, Medicaid, and interest on the federal debt. Rising marginal tax rates can be particularly harmful to economic efficiency because they reduce people's incentives to work and save, and the resulting losses in efficiency tend to increase disproportionately with the level of the tax rate.⁸ Paying down the debt reduces the pressure to raise tax rates in the future.

Generational Equity

Debt reduction would also be likely to alter the distribution of resources among various groups, particularly among generations, but it is hard to predict exactly who would gain and who would lose. Among other things, that answer would depend on what policymakers did to address the rising costs of the government's entitlement programs for the elderly. In any case, the more that resources were reallocated from current generations to future generations, the larger the positive effects on GDP in the long run.

Ultimately, decisions about saving surpluses involve a judgment about how to allocate resources among generations. There are two opposing considerations. As noted earlier, spending on the elderly is set to rise sharply over the next several decades, which could place significant burdens on future generations of workers, who will have to finance that spending. But by the same token, those future generations are likely to be more affluent than the generations that preceded them.

Flexibility for Future Policymakers

The U.S. government's ability to borrow large sums of money at a reasonable cost is a valuable asset. The need to finance the retirement of the baby boomers is one foreseeable event that is likely to absorb

Economic Efficiency

Paying down the debt could also improve the efficiency of the economy by helping to smooth marginal

8. Those losses rise roughly with the square of the tax rate. For a non-technical discussion of this issue, see Harvey Rosen, *Public Finance*, 5th ed. (Homewood, Ill.: Richard D. Irwin, 1999).

future borrowing capacity—but other unanticipated costs could arise as well. Just as households tend to save when times are good and borrow to offset hard times, the government can save by reducing debt now in order to free up the capacity to borrow in the future, when there is likely to be a more urgent need for spending.

Paying down the debt is thus a way to prepare for unexpected events. CBO's current projections of the surplus are very uncertain. Although the current budget outlook is bright, it could darken considerably if the recent burst in productivity growth proved temporary, tax revenues as a share of GDP declined, or the costs of Medicare and Medicaid grew faster than projected. In January 2001, CBO developed a scenario incorporating those factors and found that on-budget surpluses would not continue in that scenario. Instead, on-budget deficits would rise to about \$140 billion a year by 2011.⁹ As noted earlier, projections of the surplus are also based on current law and projections of discretionary spending. As a result, legislative changes could substantially alter the budget outlook.

Effects on Financial Markets

Many private investors hold government debt in their portfolios because it provides a relatively safe return and is highly liquid (that is, it can be easily bought and sold). Financial market makers (people who actively buy and sell securities, providing immediate liquidity to other market participants) also use Treasury securities as a benchmark to price other assets. If government debt were paid off, investors would have to adjust their portfolios, and market makers would have to change some of their procedures for pricing assets.

Buying back every single outstanding government bond would be expensive. The Treasury does not have the right to redeem many of its outstanding bonds before they mature, so the only way for the government to pay them off early is to buy them on the open market. As the outstanding stock of debt dwindled, it might be harder to persuade the remain-

ing bondholders to sell (especially if they had to pay taxes on their capital gains), and prices for those bonds could rise significantly. CBO does not expect the Treasury to buy back all outstanding debt. For example, it projects that in 2006, the debt that would be unavailable for redemption would total \$1.25 trillion.

Although the impact on financial markets of paying off the debt is uncertain, investors would probably be able to find alternative assets that were relatively safe. Moreover, U.S. financial markets—which are the most innovative in the world—would most likely create new financial instruments to satisfy investors' demands. However, those alternative assets might not be as liquid as Treasury securities are today; in addition, investors would have to hold assets that were probably not as safe as government debt. Nevertheless, because the cost of guaranteeing government debt is ultimately borne by taxpayers, investors' losses might be largely offset by taxpayers' gains.

The long-term cost of losing Treasury securities as a benchmark for pricing other financial instruments is likely to be very small. Recent buybacks of government debt and the expectation of further debt reduction have led market makers to search for alternatives. With seemingly little disruption, participants in financial markets are already shifting to other benchmarks.¹⁰

Although the Federal Reserve uses Treasury securities to carry out some of its important functions (such as buying and selling securities on the open market as a way to influence the economy), it would still be able to perform open-market operations if federal debt was not available. Open-market operations can be carried out using any liquid asset. However, the Federal Reserve would have to work through a number of practical problems, and policymakers might have to change the Federal Reserve's charter to allow it to use other assets.

9. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002-2011* (January 2001), Chapter 5.

10. For more information, see Michael J. Fleming, "The Benchmark U.S. Treasury Market: Recent Performance and Possible Alternatives," *Economic Policy Review*, Federal Reserve Bank of New York, vol. 6, no. 1 (April 2000), pp. 129-145.

Government Accumulation of Assets

If current laws controlling revenues and outlays do not change, the government will be able by 2006 to pay off all of the federal debt that is available for redemption, CBO projects. After that date, the total budget surpluses could be used to purchase nonfederal assets, such as stocks and bonds.¹¹ CBO's projections indicate that by 2011, the government could have a stock of private assets totaling almost \$3.2 trillion, which would represent nearly 20 percent of GDP, or about 7 percent of the total value of U.S. corporate equities and debt (at their current value relative to GDP).¹² Assuming that current policies continued, the government's share of the equity and bond markets would continue to grow after 2011.¹³

Although asset accumulation can increase the funds available for capital investment and boost economic growth, it would be unprecedented for the federal government to hold such a large stock of private assets. The potential accumulation of assets raises broad philosophical issues about whether it would be appropriate for the government to own and possibly control private companies.¹⁴ It also raises economic questions: Would the government's involvement distort market signals and corporate decisionmaking? And could the government fully insulate its decisions about buying and selling stocks from the political process?

Economic theory and the experience of other governments provide some insights, but answers to those questions would depend on how the investments were selected, the portfolio managed, and the asset-purchase program overseen. In principle, the government could reduce the impact of its investments on the economy by investing in index funds, maintaining a passive stance, and letting private shareholders determine corporate behavior. In addition, the investments could be managed by a board that was subject to strict fiduciary rules. According to economic theory, if financial markets were efficient and government investments in any particular stock were not too large, the government would not significantly affect the prices of equities selected for its index or alter the allocation of capital among firms.

However, financial markets may not behave the way simple economic models predict, and putting a company's stock in the government's index could provide a liquidity benefit that could influence stock prices and capital flows. For example, a stock's price often increases when the stock is listed in the S&P 500 index—an event that might affect its liquidity in the same way as its inclusion in a list of assets purchased by the federal government.¹⁵

Many state pension funds invest in stocks and bonds, and those funds held about \$2.5 trillion in corporate debt and equities in the third quarter of 2000—about 9 percent of the U.S. corporate equity and debt market. The experience of the states in insulating their investment decisions from politics is mixed: in some cases, investment policies have bent to political pressure, and the performance of the portfolios has suffered. However, the overall returns on state and local pension fund investments (adjusted for risk) are similar to those on private funds, suggesting that political influence may not have greatly interfered with the pursuit of market returns.

Some countries have also built up substantial stocks of government-owned private assets.¹⁶ Nor-

11. This scenario would require a change in law since the Treasury is not currently allowed to invest in corporate stocks and bonds.

12. The value of U.S. corporate equities and debt was about 2.7 times GDP in the third quarter of 2000. For the purposes of this calculation, corporate equities and debt include the market value of domestic corporations, corporate bonds, agency securities, and open-market paper.

13. In October 2000, CBO estimated that the federal government's asset holdings could balloon to 50 percent of GDP by 2030 under current policies. Since then, the long-term budget outlook has become more optimistic, so projections of asset holdings based on the current 10-year baseline would be even larger.

14. For various views on this topic, see the statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Senate Budget Committee, January 25, 2001, and the statement of David M. Walker, Comptroller General of the United States, before the Senate Budget Committee, February 6, 2001.

15. Statement of Kevin Hassett, Resident Scholar, American Enterprise Institute, before the House Ways and Means Committee, February 13, 2001.

16. General Accounting Office, *Budget Surpluses: Experiences of Other Nations and Implications for the United States*, GAO/AIMD-00-23 (November 2, 1999).

way, for example, has accumulated net assets (primarily foreign bonds and equities) totaling almost half of its GDP. It limits political interference by delegating the management of those investments to its central bank. However, Norway is a relatively small country whose actions would not be expected to affect financial markets to any appreciable extent. Moreover, its decision to invest primarily in foreign securities limits its potential scope for distorting the activities of its private sector.

The federal government has been relatively successful in managing the Thrift Saving Plan (TSP), which invests in equity and bond markets through broad-based indexes and provides retirement benefits to federal workers through a system of individual accounts. A crucial feature of the TSP is that its assets are owned by federal workers, not the government, and the board that oversees the program has a fiduciary responsibility to manage those assets for the sole benefit of the owners of those individual accounts.

If policymakers decided that the federal government should not invest in private assets, it would be desirable to make smooth changes in fiscal policy over a period of time rather than to suddenly cut taxes or increase spending when the debt available for redemption was paid off. Sharp policy changes run the risk of causing economic disruptions.

Conclusions

Paying down debt is sometimes viewed as unimaginative and “not doing anything” with the surplus. But debt reduction has potentially important consequences for the economy. It could boost national saving and increase investment in the U.S. capital stock and net foreign assets. With more capital, workers would become more productive and earn higher wages. The economy could be larger, taxpayers could be better able to finance future spending needs, and the government could be better prepared to deal with unexpected events.

The surpluses projected under current law are large enough that the federal government could pay off all debt held by the public that is available for redemption by 2006. After that point, surpluses could be invested in nonfederal assets, which could grow to unprecedented levels. Using surpluses for debt reduction carries an opportunity cost. If some or all of an annual surplus goes to pay off debt, it will not be available today for other uses—such as increasing spending or cutting taxes.